KERR-McGEE CORPORATION

IBLA 74-213 Decided September 26, 1975

Appeal from a decision of the Oil and Gas Supervisor, Roswell, New Mexico, denying royalty deduction for transportation costs and assessing payments for overdue royalty on oil and gas leases granted by the Navajo Tribe, 14-20-0603-8823, etc.

Set aside and remanded.

1. Accounts: Payments -- Indian Lands: Leases and Permits: Oil and Gas -- Indian Lands: Oil and Gas Leasing: Tribal Lands -- Oil and Gas Leases: Production -- Oil and Gas Leases: Royalty

Reasonable transportation costs of production from oil and gas leases from the field to the first available market are allocable to the Federal or Indian royalty interest.

APPEARANCES: William E. Heimann, Esq., Vice President and General Counsel, and James W. Roberts, Esq., Attorney, Kerr-McGee Corporation, for appellant.

OPINION BY ADMINISTRATIVE JUDGE HENRIQUES

In 1964 and 1965, the Navajo Tribe of Indians, with approval of the authorized representative of the Secretary of the Interior, issued three oil and gas leases on tribal lands to Kerr-McGee Oil Industries, Inc. The leases were made pursuant to 25 CFR 171.2, and were set forth on BIA Form 5-157 (Jan. 1962), identified, respectively, as Contracts 14-20-0603-8823, 14-20-0603-8822, and 14-20-0603-8889 [hereinafter referred to as leases 8823, 8822 and 8889].

Among the lease terms is a requirement to pay rental annually in advance at the rate of $1.25 per acre, to be credited on the royalty of 16-2/3 percent of the value of all oil, gas and/or natural gasoline and/or all other hydrocarbon substances produced and saved from the lands leased -- the "value" of the production to be determined by the Oil and Gas Supervisor, U.S. Geological Survey, as the designate of the Secretary of the Interior; to abide by and conform to any and all regulations now or hereafter in force relative to such lease, including 30 CFR Part 221, Provided, that no regulation hereafter approved shall effect a change in rate of royalty or annual rental therein specified without the written consent of the parties to this lease.

Oil in paying quantities was discovered under these leases and production thereof commenced. Early production was transported by truck some 39 miles at a cost of between 24 cents and 35 cents per barrel to a receiving point on the Four Corners Pipeline operated by Shell Oil Company in San Juan County, New Mexico. Anticipated recoverable oil from the pool under these leases prompted the construction of an oil pipeline by the Kerr-McGee Pipeline Company from lease 8823 to Navajo Junction on the Four Corners Pipeline of Shell Oil Company, and a gathering system from leases 8822 and 8889 to the initial point of the Kerr-McGee pipeline on lease 8823. Kerr-McGee Pipeline Company established local tariffs of 10 cents a barrel for the gathering system and 15 cents a barrel for transportation from lease 8823 to Four Corners.

By letter of February 1, 1968, the Oil and Gas Supervisor advised the lessee that, on the basis of cost figures provided by the pipeline company, the 15 cents per barrel transportation tariff was justified until the cost of the pipeline was recovered, that 10 cents a barrel gathering charge could not be allowed for lease 8823, but would be allowed for leases 8822 and 8889 and other leases in the field, and that the lessor's royalty charges from the initial pipeline delivery through the Four Corners Pipeline were being adjusted to the basis of Shell's posted price for the Four Corners area plus 5 cents a barrel gathering allowance by the purchaser less 15 cents a barrel transportation tariff.

Following receipt of cost figures from Kerr-McGee which showed that the capital investment in the pipeline was $567,925, and that this sum had been recovered after transportation of 3,786,167 barrels of oil through the pipeline, the Oil and Gas Supervisor, in letter of January 25, 1971, advised Kerr-McGee that the Geological Survey records showed that the cost of the pipeline has been recovered during July 1968, when the cumulative total of 3,786,167 barrels of oil had been transported. Therefore, in conformance with the letter of February 1, 1968, which allowed a transportation deduction of 15 cents a barrel from "value" only until the cost of the pipeline was recovered, royalty due to lessor since July 1968, had been recomputed on the basis of Shell's posted price plus 5 cents for lease 8823, and on the basis of Shell's price plus 5 cents per barrel less 10 cents per barrel gathering charge for leases 8822 and 8889. Demand was made for payment of overdue royalty of $108,555.09, representing $33.45 on lease 8822, $94,404.67 on lease 8823, and $14,116.97 on lease 8889.

Kerr-McGee paid the demand under protest and appealed by letter of January 25, 1971. Subsequent demands for increased royalty payment have likewise been paid under protest.

No action on the appeal was taken by the Commissioner of Indian Affairs until the Commissioner, by memorandum of January 9, 1974, referred the matter to the Office of Hearings and Appeals. Pursuant to 43 CFR 4.5, the Director of the Office of Hearings and Appeals on March 5, 1974, exercising his supervisory authority, took jurisdiction of the appeal and assigned the case to the Board of Land Appeals for decision.

Appellant contends that the decision of the Oil and Gas Supervisor is in error and that legal precedents clearly establish its right to a reasonable deduction for transportation costs. After careful consideration we find ourselves in agreement with the appellant and accordingly reverse the decision below to the extent that it held that no transportation costs were allocable to the Indian royalty interest.

The Department has long held that the costs of conditioning oil or gas in order to put it in a marketable state are not allocable to the federal royalty interest. This result has been premised on the fact that federal oil and gas lessees have the contractual obligation to place the production of such substances in a marketable condition. The California Co., 66 I.D. 54 (1959), aff'd, 296 F.2d 384 (D.C. Cir. 1961); The Texas Co., 64 I.D. 76 (1957). Similarly, the Department has refused to allow deductions from the price received by lessees for transportation costs from one point in the field to a selling point in the same field. The California Co., supra; The Texas Co., supra. This Department has never ruled, however, that transportation costs are not recoverable on a pro rata basis when there is no market in the field. On the contrary, the Department, in Shell Oil Co., 70 I.D. 393 (1963), specifically noted that "[o]il and gas leases executed pursuant to the Mineral Leasing Act have been construed to allow for the deduction of transportation costs in the computation of market values and royalty interests." Id. at 395, fn. 6.

In The Texas Co., supra, the Department distinguished transportation to a selling point in the field from transportation out of the field to a market place. Id. at 79-80. In like manner, the D.C. Circuit Court of Appeals noted in The California Co. case, supra, that:

> [n]o transportation costs are involved in this case. The Secretary is not here claiming that costs incurred in moving gas from the field in the neighborhood of the wells to a distant selling point are includable in the royalty base. This gas was conditioned by the seller and delivered to the purchaser in the field within a short distance of the wells. There were no transporting costs.

Id. at 387.

In Superior Oil Company, 12 IBLA 212 (1973), this Board denied a barging allowance for transportation of crude oil from Burns Terminal to Marrero, Louisiana, a distance of some 90 miles. Superior ran oil from an OCS lease into a flowline jointly owned by Mobil Oil Company, Continental Oil Company, and Newmont Oil Company [MCN], running from offshore leases to onshore facilities at the Burns Terminal in Louisiana. Superior's oil was commingled with that of Mobil, Continental and Newmont, each of whom disposed of its crude at Burns Terminal and paid royalty to the United States based on the stated price at Burns Terminal. Superior barged its oil from Burns Terminal to Hess, at Marrero, and paid royalty on the price received from its purchaser at Marrero. The Director, Geological Survey, denied Superior's request for transportation allowance for shipping its crude oil by barge from Burns Terminal to Marrero. Superior maintained that because it had no arms length market at Burns Terminal it was entitled to transportation costs from Burns Terminal to wherever such market existed. This Board, stated that Shell, supra, authorizes but does not compel the Secretary to make a transportation allowance in computing the royalty base for OCS crude oil, and affirmed the Geological Survey's denial of Superior's request.

Superior is distinguishable from the case at bar in that Superior was seeking an allowance for transportation beyond the point of the first potential market, Burns Terminal, and at which market the royalty base was deemed to be established. Kerr-McGee is seeking a transportation allowance only from its leasehold to the point of the first market. Cf. Ocean Drilling & Exploration Co., 21 IBLA 137 (1975).

[1] Logic as well compels the conclusion that such costs are properly considered for a transportation allowance. The Government under the lease terms reserves the right to take its royalty in kind instead of its value. The lease provisions provide that "when royalty on oil produced is paid in kind, such royalty oil shall be delivered in tanks provided by the lessee on the premises, where produced without cost to the lessor * * *." (Emphasis added.) But having taken possession of the oil at the field, the Government would obviously have to bear the transportation costs. It would be an anomalous result if the Government royalty interest was, in effect, chargeable with transportation when taken in kind, but not when taken in value. We hold that where, as in the instant case, there is no market for oil or gas production in the field where it is produced, the Indian royalty interest is chargeable with reasonable transportation costs to the market for its pro rata share.

Furthermore, we note that subsequent to the decision below, the Chief, Conservation Division, U.S.G.S., issued guidelines on the computation and determination of transportation allowances. Therein it provides:

> * * * For a lessee-owned and -operated pipeline, the applicable allowance should be calculated by setting up a depreciation schedule for the estimated future life of the pipeline as shown in CDM 647.5A. The investment cost used in this schedule should be the current depreciated value of the pipeline plus or minus interest on excessive or insufficient amounts allowed in the past when such interest would be significant. If the prior allowance has been granted on an amortization basis and the cost of the pipeline has been amortized, actual reasonable operating costs should be allowed as deductions in the future. (Emphasis added.)

5 CDM 647.5.3F

In view of the above, the case files will be remanded in order for the Geological Survey to determine what would be a reasonable allowance for transportation costs in the instant case.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case files are remanded for action not inconsistent with this opinion.

Douglas E. Henriques
Administrative Judge

We concur:

Martin Ritvo
Administrative Judge

Edward W. Stuebing
Administrative Judge